

Part I

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-1: General rule for methods of accounting.
(Also § 118)

Rev. Rul. 2008-30

ISSUE

Does the change from (1) treating certain payments received from customers as contributions to capital under § 118(c) of the Internal Revenue Code to (2) treating the payments as taxable customer connection fees constitute a change in method of accounting within the meaning of §§ 446 and 481 and the regulations thereunder?

FACTS

U corporation is a regulated public utility that operates and maintains sanitary sewer lines and sewerage disposal plants. U charges a “customer connection fee” to certain customers when U must build lines to extend its existing infrastructure to the customer in order to start sewerage disposal services. These customer connection fees finance U’s construction of sewer line extensions to the customer.

In Years 1, 2 and 3, U treats the customer connection fees as contributions in aid of construction (CIACs) within the meaning of § 118(c) and excludes the customer connection fees from U's gross income as contributions to capital under § 118(a). As required by § 118(c)(4), U takes an adjusted basis of zero in the sewer line extensions that it constructs and finances with the customer connection fees.

In Year 4, U concludes that its customer connection fees are properly includible in gross income because the exclusion provided by § 118(c) does not apply. Beginning in Year 4, U includes customer connection fees in gross income and capitalizes the cost of the sewer line extensions constructed and financed with these fees. U claims depreciation deductions for the capitalized cost of these sewer line extensions over the recovery period prescribed under § 168.

LAW

Section 61(a) and the regulations thereunder define gross income to mean, except as otherwise provided, all income from whatever source derived.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Section 118(c)(1) provides that the term “contribution to the capital of the taxpayer” includes certain amounts received by regulated public water and sewerage disposal utilities as a CIAC. Under § 118(c)(4), the adjusted basis of any property acquired with a CIAC that is excludable from gross income under § 118(c) is zero.

Section 446(e) requires a taxpayer who changes its method of accounting to secure the consent of the Commissioner before computing its taxable income under the

new method. Under § 1.446-1(e)(2)(ii)(a) of the Income Tax Regulations, a change in a method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in the overall plan of accounting. A material item is any item the treatment of which affects the proper time for including income or taking a deduction. § 1.446-1(e)(2)(ii)(a). The key characteristic of a material item “is that it determines the timing of income or deductions.” Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984).

The relevant question is generally whether the treatment of the item permanently changes the amount of taxable income over the taxpayer’s lifetime. If the treatment does not permanently affect the taxpayer’s lifetime taxable income, but does or could change the taxable year in which taxable income is reported, the treatment affects timing and is therefore a method of accounting. See Knight-Ridder Newspapers, Inc., 743 F.2d at 799; Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969); Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Rev. Proc. 91-31, 1991-1 C.B. 566, § 3.02.

A change in method of accounting does not include an adjustment of any item of income or deduction that does not affect the proper time for including the item in income or taking a deduction. § 1.446-1(e)(2)(ii)(b). For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and corrections of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. Id.

Section 481(a) requires a taxpayer to take into account any adjustment to taxable income necessary to prevent amounts from being duplicated or omitted as a result of a change in method of accounting.

In Saline Sewer Co. v. Commissioner, T.C. Memo. 1992-236, the Tax Court held that a change from excluding customer connection fees from gross income, as nontaxable CIACs under § 118, to including the customer connection fees in gross income was not a change in method of accounting because, according to the court, “no timing issue [wa]s involved.” 63 T.C.M. (CCH) 2834. The taxpayer in Saline Sewer treated customer connection fees as an excludable CIAC under § 118, which required an adjusted basis of zero in the improvements constructed with these fees. Upon examination of the taxpayer’s income tax return, the Service determined that the customer connection fees did not qualify for the exclusion under § 118. The Service proposed to change the taxpayer’s method of accounting to include customer connection fees in income and increase the depreciable basis of the improvements constructed with these fees.

In reaching its conclusion that the change imposed by the Service did not constitute a change in method of accounting, the court analyzed the receipt of the customer connection fees independently from the effect on depreciable basis of the improvements constructed with those fees. The court concluded that a change from excluding customer connection fees from income to including them in income gives rise to a permanent difference in lifetime income, not a timing difference, and therefore is not a change in accounting method. Similarly, the court concluded that a change in the

depreciable basis of the improvements results in a permanent difference in the amount of depreciation deductions allowed, and that this change is not a change in accounting method. The court did not consider the effect of the combined changes in income, basis, and depreciation on the taxpayer's lifetime taxable income. See also Florida Progress Corp. v. United States, 156 F.Supp.2d 1265, 1276 (M.D. Fla. 1999) (relying upon Saline Sewer and holding that the change in treatment of customer connection fees was not a change in method of accounting), *aff'd per curiam on other issues*, 264 F.3d 1313 (11th Cir. 2001).

ANALYSIS

Whether U's change to the treatment of its customer connection fees is a change in method of accounting depends upon whether the change permanently affects U's lifetime taxable income. If U's change has no effect on its lifetime taxable income, but affects only the timing of that income, then it is a change in method of accounting. "Taxable income," as defined in § 63, means gross income minus allowable deductions. Therefore, an analysis of the effect of U's change on lifetime taxable income must consider the effect on both income and deductions.

Section 118 affects both the gross income and the deduction of CIACs qualifying under § 118(c). Section 118(c)(1) excludes the customer connection fees from gross income, and § 118(c)(4) mandates a depreciable basis of zero for the improvements constructed with these customer connection fees, resulting in no depreciation or other deduction. The net effect of § 118(c) is to deny depreciation deductions for infrastructure developed with funds previously excluded from income.

See Small Business Job Protection Act of 1996, H.R. Rep. No. 104-737, at 316 (1996) (indicating that the designation “contributions in aid of construction” impacts both gross income and basis).

U’s lifetime taxable income with respect to its customer connection fees is the same whether those fees are treated as (1) gross income followed by allowable depreciation deductions or (2) nontaxable CIACs resulting in zero basis and no depreciation deductions. Under its existing treatment, U excludes the customer connection fees from gross income and can take no depreciation deductions because the customer connection fees are not included in the depreciable basis of the assets constructed with the fees. See § 118(c). Under its contemplated treatment, U includes the customer connection fees in gross income and may take depreciation deductions (over the assets’ recovery periods) because the customer connection fees create depreciable basis in the assets constructed with the fees. Thus, U’s lifetime taxable income will be the same under either treatment because there are corresponding and offsetting changes in U’s gross income and deductions. Accordingly, U’s change from treating customer connection fees as nontaxable CIACs under § 118(c) to treating the payments as includible in gross income constitutes a change in method of accounting within the meaning of §§ 446 and 481 and the regulations thereunder. See Johnson v. Commissioner, 108 T.C. 448, 495 (1997) (both income and related offsetting deductions are considered when determining if lifetime income is affected), *aff’d in part, rev’d in part*, 184 F.3d 786, 790 (8th Cir. 1999); Rankin v. Commissioner, 138 F.3d 1286, 1289 (9th Cir. 1998) (combined effect of current-year deductions and offsetting income in

future years must be considered in determining whether a change in method of accounting occurs); see also Rev. Proc. 2002-9, 2002-1 C.B. 327, §§ 1.01, 1A.01 of the APPENDIX.

The legislative history of § 118 supports this conclusion. When originally enacted, § 118 functioned much as it does today: it allowed certain regulated public utilities to exclude CIACs from gross income (and required a reduction in depreciable basis). The legislative history is clear that Congress viewed the exclusion as a method of accounting. See S. Rept. No. 94-938, at 436 (1976) (“If a taxpayer wishes to change its present practice of treating contributions in aid of construction to a practice which is consistent with this provision, such change constitutes a change in method of accounting”). The exclusion for CIACs was repealed but reenacted in 1996. In reenacting the exclusion, Congress did not address or revisit the question of whether a change to or from § 118 treatment is a change in method of accounting. See H.R. Rep. No. 104-737, at 316 (1996).

HOLDING

A change from treating certain payments received from customers as nontaxable contributions to capital under § 118(c) to treating the payments as taxable customer connection fees is a change in method of accounting under §§ 446 and 481. Similarly, a change from treating customer connection fees as taxable customer connection fees to nontaxable contributions to capital under § 118(c) constitutes a change in method of accounting under §§ 446 and 481.

For the foregoing reasons, the Service does not acquiesce in the holdings on this issue in Saline Sewer Co. v. Commissioner, T.C. Memo. 1992-236, and Florida Progress Corp. v. United States, 156 F.Supp.2d 1265 (M.D. Fla. 1999).

DRAFTING INFORMATION

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